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HOUSE OF REPRESENTATIVES
REPORT
No. 91-1696

INCOME TAX TREATMENT OF CERTAIN SALES BY A CORPORATION OF REAL PROPERTY HELD MORE THAN 25 YEARS

DECEMBER 9, 1970.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. BOGGS, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 19790]

The Committee on Ways and Means, to whom was referred the bill (H.R. 19790) relating to the income tax treatment of certain sales of real property by a corporation, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Page 1, line 4, strike out "sold of" and insert "sold or"
Page 2, line 2, strike out "held for" and insert "(i) held for"
Page 2, line 3, strike out "or exchange" and insert "or exchange, and (ii)"
Page 4, beginning in line 16, strike out "In case" and all that follows down through line 23.

I. SUMMARY

H.R. 19790 is concerned with the provision in present law (sec. 1237) specifying cases where those who subdivide property for sale may obtain capital gains treatment, as distinct from ordinary income treatment, with respect to the gain involved. In 1956, Congress acted to make this provision available in the case of corporations acquiring property, which subsequently is subdivided, as a result of the foreclosure of a lien and also to property adjacent to the foreclosed property. Because of difficulties in administering and interpreting this provision, this bill substitutes a perfecting amendment clarifying the intent of the original provision. In general terms, this restricts the capital gains treatment in the case of corporations to situations where property was acquired by foreclosure of a lien before 1934, where the property has been held for 25 years before sale, and where no additional property was acquired after 1956. The provision also applies to

property in the near vicinity of the foreclosed property so long as it does not constitute more than 20 percent of the property sold in any year. This provision applies to sales made after 1957 but only to years which are open at the time of enactment of this bill.

This bill has been reported unanimously by your committee, and the Treasury Department indicated no objection to its enactment.

II. REASONS FOR THE BILL

In 1956, Congress amended the tax law to provide that in certain cases corporations, as well as individuals, could subdivide real property for sale without this giving rise to ordinary income (sec. 1237). The amendment made in 1956 (Public Law 84–495 (H.R. 6712)), was generally applicable only to cases where property was acquired through the foreclosure of a lien which secured the payment of a debt. However, the provision also covered nearby property if 80 percent of the property sold in any year was obtained through the foreclosure of the lien. Where these conditions existed, the 1956 congressional action provided that the capital gain treatment was to be available whether or not it was shown to the satisfaction of the Internal Revenue Service that the value of the land was enhanced by certain improvements which ordinarily would make a taxpayer a dealer. In addition, in this type of situation the taxpayer need not elect to forego any adjustment to the basis of the land on account of the expenditures for these improvements.

The Internal Revenue Service, in administering and interpreting this provision, has not made the relief provided under it available in the types of situations Congress intended to cover. For this reason, your committee in this bill has acted to make perfectly clear the types of situations originally intended to be covered.

Because Congress acted on this matter in the middle 1950's, the action taken here applies to all taxable years after 1957. It does not, however, cover years which are closed at the time of the date of enactment of the bill.

III. EXPLANATION OF THE BILL

The bill, in general, provides that a corporation which had held land for more than 25 years at the time of its sale and which acquired that land before 1934, as a result of a foreclosure of liens, may subdivide and sell that land and pay capital gains tax, rather than ordinary income tax, on the proportion of the gain exceeding 5 percent of the selling price. The gain to the extent of 5 percent of the selling price is taxed as ordinary income (in effect it is treated as a commission on the sale).

In addition, the capital gains treatment described above also applies to property acquired before 1957 in the near vicinity of the property acquired by foreclosure (and to certain other minor acquisitions [1]) but only if 80 percent of the real property (in terms of area) sold during the taxable year in question is property acquired as the result of a foreclosure.

[1] Acquisitions made to adjust boundaries, to fill gaps in previously acquired property, to facilitate the installation of streets, utilities, and other public facilities, or to facilitate the sale of adjacent property.

In administering the 1956 provision there have been difficulties in determining what constituted "adjacent" property. It is for this reason that the bill refers to acquisitions "in the near vicinity of" the property acquired by foreclosure. This makes it clear that the land acquired after the foreclosure may come within the terms of the bill as long as it was close enough to the foreclosed property to make joint promotion and development feasible, even though parcels of such land do not abut on, or are not contiguous or adjacent to, the foreclosed property.

The bill applies only to taxable years beginning on or before December 31, 1983. Your committee believes a termination date of this type is appropriate because the types of cases intended to be covered are essentially liquidating operations for property acquired before 1957. This should provide adequate time to complete sales of such property.

The bill applies to taxable years beginning after December 31, 1957, but does not reopen any taxable year closed on the date of enactment of the bill. It does not authorize the making of any refund or the allowance of any credit or the assessment of any deficiency for any period before the date of enactment of the bill if, on that date this action is prevented by any law or rule of law. Thus, for example, no refund or credit may be claimed as to any years with respect to which a closing agreement (described in sec. 7121) was entered into, or as to which liability was compromised (under sec. 7122 of the code).

The bill also amends the Internal Revenue Code of 1954 to make the provision relating to real property subdivided for sale (sec. 1237) inapplicable to corporations (although, of course, this bill preserves for corporations meeting the conditions set forth in it, many of the benefits of that section). The amendment brings this provision back to the text prior to the 1956 Act insofar as the changes made by that Act related to corporations. This change is effective for taxable years beginning after the date of enactment of the bill.

IV. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

SECTION 1237 OF THE INTERNAL REVENUE CODE OF 1954

SEC. 1237. REAL PROPERTY SUBDIVIDED FOR SALE.

(a) GENERAL.—Any lot or parcel which is part of a tract of real property in the hands of a taxpayer [(including corporations only if no shareholder directly or indirectly holds real property for sale to customers in the ordinary course of trade or business and only in the case of property described in the last sentence of subsection (b)(3))] *other than a corporation* shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because of the taxpayer having subdivided such

tract for purposes of sale or because of any activity incident to such subdivision or sale, if—

(1) such tract, or any lot or parcel thereof, had not previously been held by such taxpayer primarily for sale to customers in the ordinary course of trade or business (unless such tract at such previous time would have been covered by this section) and, in the same taxable year in which the sale occurs, such taxpayer does not so hold any other real property; and

(2) no substantial improvement that substantially enhances the value of the lot or parcel sold is made by the taxpayer on such tract while held by the taxpayer or is made pursuant to a contract of sale entered into between the taxpayer and the buyer. For purposes of this paragraph, an improvement shall be deemed to be made by the taxpayer if such improvement was made by—

(A) the taxpayer or members of his family (as defined in section 267 (c) (4)), by a corporation controlled by the taxpayer, or by a partnership which included the taxpayer as a partner; or

(B) a lessee, but only if the improvement constitutes income to the taxpayer; or

(C) Federal, State, or local government, or political subdivision thereof, but only if the improvement constitutes an addition to basis for the taxpayer; and

(3) such lot or parcel, except in the case of real property acquired by inheritance or devise, is held by the taxpayer for a period of 5 years.

(b) Special Rules for Application of Section.—

(1) Gains.—If more than 5 lots or parcels contained in the same tract of real property are sold or exchanged, gain from any sale or exchange (which occurs in or after the taxable year in which the sixth lot or parcel is sold or exchanged) of any lot or parcel which comes within the provisions of paragraphs (1), (2) and (3) of subsection (a) of this section shall be deemed to be gain from the sale of property held primarily for sale to customers in the ordinary course of the trade or business to the extent of 5 percent of the selling price.

(2) Expenditures of sale.—For the purpose of computing gain under paragraph (1) of this subsection, expenditures incurred in connection with the sale or exchange of any lot or parcel shall neither be allowed as a deduction in computing taxable income, nor treated as reducing the amount realized on such sale or exchange; but so much of such expenditures as does not exceed the portion of gain deemed under paragraph (1) of this subsection to be gain from the sale of property held primarily for sale to customers in the ordinary course of trade or business shall be so allowed as a deduction, and the remainder, if any, shall be treated as reducing the amount realized on such sale or exchange.

(3) Necessary improvements.—No improvement shall be deemed a substantial improvement for purposes of subsection (a) if the lot or parcel is held by the taxpayer for a period of 10 years and if—

(A) such improvement is the building or installation of water, sewer, or drainage facilities or roads (if such improve-

ment would except for this paragraph constitute a substantial improvement);

(B) it is shown to the satisfaction of the Secretary or his delegate that the lot or parcel, the value of which was substantially enhanced by such improvement, would not have been marketable at the prevailing local price for similar building sites without such improvement; and

(C) the taxpayer elects, in accordance with regulations prescribed by the Secretary or his delegate, to make no adjustment to basis of the lot or parcel, or of any other property owned by the taxpayer, on account of the expenditures for such improvements. Such election shall not make any item deductible which would not otherwise be deductible.

[The requirements of subparagraphs (B) and (C) shall not apply in the case of property acquired through the foreclosure of a lien thereon which secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of its stock and other consideration and in the case of property adjacent to such property if 80 percent of the real property owned by the taxpayer is property described in the first part of this sentence.]

(c) TRACT DEFINED.—For purposes of this section, the term "tract of real property" means a single piece of real property, except that 2 or more pieces of real property shall be considered a tract if at any time they were contiguous in the hands of the taxpayer or if they would be contiguous except for the interposition of a road, street, railroad, stream, or similar property. If, following the sale or exchange of any lot or parcel from a tract of real property, no further sales or exchanges of any other lots or parcels from the remainder of such tract are made for a period of 5 years, such remainder shall be deemed a tract.

(d) EFFECTIVE DATE.— This section shall apply only with respect to sales of property occurring after December 31, 1953, except that, for purposes of subsection (c) (defining tract of real property) and for determining the number of sales under paragraph (1) of subsection (b), all sales of lots and parcels from any tract of real property during the period of 5 years before December 31, 1953, shall be taken into account, except as provided in subsection (c).

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